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DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[REG-160330-02]

RIN 1545-BB65

Section 704(c), Installment Obligations and Contributed Contracts

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed regulations relating to the tax treatment of installment obligations and property acquired pursuant to a contract under sections 704(c) and 737. The proposed regulations affect partners and partnerships and provide guidance necessary to comply with the law.

DATES: Written and electronic comments and requests for a public hearing must be received no later than February 23, 2004.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG-160330-02), room 5203, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may also be hand delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to: CC:PA:LPD:PR (REG-160330-02), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW., Washington, DC. Alternatively, taxpayers may submit electronic comments directly to the IRS Internet site at: www.irs.gov/regs.

FOR FURTHER INFORMATION CONTACT: Concerning the regulations, Christopher L. Trump, 202-622-3070; concerning submissions and the hearing, Robin Jones, 202-622-3521 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

Section 704(c)(1)(A) provides that income, gain, loss or deduction with respect to property contributed to a partnership by a partner shall be shared among the partners so as to take into account the variation between the basis of the property to the partnership and its fair market value at the time of the contribution.

Under section 704(c)(1)(B) and the regulations thereunder, any partner that contributes section 704(c) property to a partnership must recognize gain or loss

on the distribution of such property to another partner within 7 years of its contribution. The amount of gain or loss recognized is the amount of gain or loss that would have been allocated to such partner under section 704(c)(1)(A) if the property had been sold by the partnership to the distributee partner for its fair market value at the time of the distribution.

Under section 737(a) and the regulations thereunder, any partner that contributes section 704(c) property to a partnership may recognize gain on a distribution of property (other than money) by the partnership to that partner. The amount of gain recognized is the lesser of: (1) The amount by which the fair market value of the distributed property exceeds the distributee partner's adjusted tax basis in the partner's partnership interest, or (2) the net precontribution gain of the partner. Section 737(b) defines the net precontribution gain of the partner as the net gain (if any) that would have been recognized by the distributee partner under section 704(c)(1)(B) if all property that (1) had been contributed to the partnership by the distributee partner within 7 years of the distribution and (2) is held by such partnership immediately before the distribution, had been distributed by such partnership to another partner.

For purposes of section 704(c)(1)(A) and (B) and section 737, if a partnership disposes of section 704(c) property in a nonrecognition transaction in which no gain or loss is recognized, the substituted basis property (within the meaning of section 7701(a)(42)) is treated as section 704(c) property with the same amount of built-in gain or loss as the section 704(c) property disposed of by the partnership. See §§ 1.704-3(a)(8), 1.704-4(d)(1), and 1.737-2(d)(3).

If a partnership disposes of property in an installment sale, income is taken into account under the installment method unless the partnership elects otherwise. See section 453. Upon the satisfaction of an installment obligation at other than its face value or the distribution, transmission, sale, or other disposition of an installment obligation, a taxpayer is generally required, under section 453B, to recognize gain or loss. Section 453B does not apply, however, on the disposition of an installment obligation in certain situations where the Internal Revenue Code (Code) otherwise provides for nonrecognition of gain or loss. For example, § 1.453-9(c)(2) provides that no gain or loss results under section 453(d) (now section 453B) in the case of a contribution to or distribution from a partnership under sections 721 or 731.

In addition, if a partnership acquires property pursuant to a contract such as an option, a forward contract, or a futures contract, the partnership may recognize no gain or loss on the acquisition of the property.

Explanation of Provisions

The proposed regulations amend § 1.704-3(a)(8) to clarify that, if a partnership disposes of section 704(c) property in exchange for an installment obligation, the installment obligation is treated as the section 704(c) property. The proposed regulations also clarify that, if a partner contributes a contract that is section 704(c) property to a partnership, and the partnership subsequently acquires property pursuant to that contract in a transaction in which less than all of the gain or loss is recognized, the acquired property is treated as the section 704(c) property for purposes of sections 704(c) and 737. For this purpose the term contract includes, but is not limited to, options, forward contracts, and futures contracts.

The proposed regulations amend § 1.704-4(d)(1) to provide that an installment obligation received by a partnership and property acquired pursuant to a contributed contract are treated as section 704(c) property for purposes of section 704(c)(1)(B) to the extent that the installment obligation or the acquired property is section 704(c) property under § 1.704-3(a)(8). As a result, if the installment obligation or property acquired pursuant to a contributed contract is distributed by a partnership to a partner other than the contributing partner within 7 years of the contribution, the contributing partner may recognize gain or loss under section 704(c)(1)(B). The proposed regulations include a similar rule under § 1.737-2(d)(3).

No inference is intended as to the treatment of these transactions under prior law.

Proposed Effective Date

These regulations are proposed to apply to installment obligations received by a partnership on or after November 24, 2003 in exchange for section 704(c) property and to property acquired on or after November 24, 2003 by a partnership pursuant to a contract that is section 704(c) property.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section